

October 31, 1991

**COORDINATED ISSUE
MOTOR VEHICLE INDUSTRY
REMANUFACTURERS' INVENTORY OF CORES**

ISSUE

Whether taxpayer may value the "core" segment of its rebuilt inventory at an amount that is less than cost or market, whichever is lower.

FACTS

Taxpayer is engaged in the business of remanufacturing motor vehicle parts. In many instances, repairs are made to motor vehicles using rebuilt or remanufactured parts. These parts include not only small items such as alternators, starters, brake shoes, but also larger items such as engines. The smaller parts are usually sold by a remanufacturer to a distributor or retailer. The distributor or retailer, upon sale of the rebuilt part, accepts the old part, or "core", as a trade-in from the customer giving the customer a credit or rebate. The cores are then returned to the remanufacturer who credits the account of the distributor or retailer. Credit is usually given for the cores before they are cleaned or inspected. After inspection, a portion of the cores are usually found to be defective and sold for salvage.

If the cores are stored in bulk containers outside, they are referred to as yard cores. Because of the uncertainty as to whether they will ever be rebuilt, taxpayers may not include their value in inventory. When the cores are actually rebuilt, a value may be assigned to them which is a fraction of the amount allowed as a credit to the distributor or retailer when they were returned.

LAW

Under Section 471 IRC whenever the use of inventories is necessary in order to clearly determine income, inventories shall be taken on such basis as the Secretary may prescribe as conforming as nearly as possible to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-2(b) of the Regulations provides that the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is in accord with Regulations 1.471-1 through 1.471-11.

Section 1.471-2(c) of the Regulations provides the bases of valuation most commonly used by business concerns and which meet the requirements of Section 471 are (1) cost and (2) cost or market, whichever is lower. These bases of valuation are accounting methods which a taxpayer adopts and cannot change without the permission of the Commissioner.

Section 1.471-3(b) of the Regulations provides that cost means, in the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts. To this net price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

For taxpayers who adopt the cost or market, whichever is lower method, the regulations prescribe two instances where inventory may be written down below cost to market. The first instance is contained in Section 1.471-4(a) of the Regulations which states in part:

"Under ordinary circumstances and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases -

(1) Of goods purchased and on hand, and (2) Of basis elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand;..."

In other words, a taxpayer may write down purchased or manufactured goods to replacement cost.

The second instance is contained in Section 1.471-4(b) of the Regulations which states in part:

"...Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition....."

Regardless of the method adopted, a taxpayer may, under certain conditions, use a value less than cost. Section 1.471-2(c) of the Regulation provides in part:

"...Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, or if such goods consist of

raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the conditions of the goods, but in no case shall such value be less than the scrap value... Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date...."

Whichever method is adopted, Section 1.471-2(d) of the Regulations provides that the method must be applied with reasonable consistency to the entire inventory of taxpayer's trade or business, except as to those goods inventoried under the last-in, first-out method. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be goods most recently purchased or produced, and the cost thereof will be the actual cost of goods purchased or produced during the period in which the quantity of goods in inventory has been acquired.

For taxpayers which have adopted the LIFO inventory method, Section 1.472-2(b) of the Regulations state that inventory must be valued at cost regardless of market.

Section 1.471-2(f) of the Regulations provides that the following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the Regulations in this part: (1) taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value, (2) omitting portions of stock on hand.

Section 1.446-1 of the I.T. Regulations states in part:

(a)(2)...Each taxpayer shall adopt such forms and systems as are, in his judgement, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income.

Section 1.446-1(a)(4) of the I.T. Regulations states:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year.

The Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), 79-1 9 USTC Par. 9139 stated, for purpose of computing the market value of purchased goods, the bid price prevailing in the particular market in which the taxpayer normally purchases its goods should be the replacement cost.

In D. Loveman & Sons Export Corp., 34 TC 776, a similar issue arose in connection with the valuation of a taxpayer's inventory of first quality steel under the lower of cost or market method. In that case, the Commissioner insisted that the proper bid price was that of the customers from whom the taxpayer had actually purchased its steel during the applicable period. The Tax Court agreed and held that the relevant market was of critical importance in determining bid price.

In Abbeyville Cotton Mills, 10 BTA 646, the court stated that another important consideration in determining the bid price for the type of goods in question, is that such bid price should be based on the quantity of goods normally purchased by the taxpayer and the quality of the goods should be comparable to those which are included in the taxpayer's inventory.

The Supreme Court in Thor Power Tool Co. made the following statement:

The Regulations specify two situations in which a taxpayer is permitted to value inventory below "market" as so defined. The first is where the taxpayer in the normal course of business has actually offered merchandise for sale at prices lower than replacement cost...

The second situation in which a taxpayer may value inventory below replacement cost is where the merchandise itself is defective. If goods are "unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes in style, odd or broken lots, or other similar causes," the taxpayer is permitted to value the goods "at bona fide selling prices less direct cost of disposition." The taxpayer bears the burden of proving that "such exceptional goods are valued upon such basis, come within the classification of goods as will enable a verification of the inventory to be made."

DISCUSSION

In accordance with the citations from the Code, Regulations, and court cases,

remanufacturers must value the cores at cost unless a lower market value can be determined. Cost is the amount allowed as a credit to customers who turn in the cores. In order to establish market value, taxpayers must substantiate the value by providing evidence of actual offerings, sales, or contract cancellations.

For cores that have been or will be remanufactured, the proper inventory value ordinarily will be cost, since these cores are not offered for sale at scrap prices and the amount allowed as a credit seldom changes. For cores that have been determined to be unsuitable for remanufacturing, the proper inventory value is cost, unless they have been offered for sale for salvage in which case they should be valued at scrap prices.

CONCLUSION

Remanufacturers must value their inventory of cores for tax purposes at cost unless they substantiate a lower inventory valuation in accordance with the provisions of the regulations.